SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Runner & Cardoza   Analyst: Marion Mann DeJong   Bill Number: AB 2461

Related Bills: See Prior Analysis   Telephone: 845-6979   Amended Date: 04/03/2000

Attorney: Patrick Kusiak   Sponsor:

SUBJECT: MIC/Change From 6% to 8% & Extend to Mineral Extraction & Certain Electric Power Generator Activities/Unlimited Carryover & Delete Repeal Date

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO _______________________.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 24, 2000, STILL APPLIES.

_____ OTHER - See comments below.

SUMMARY OF BILL

This bill would make the following changes to the Manufacturers' Investment Credit (MIC):

- increase the credit from 6% to 8% of qualified costs,
- extend the MIC to taxpayers engaged in extracting nonmetallic minerals,
- extend the MIC to specified taxpayers engaged in electric services,
- expand the current law definition of qualified activity to include extracting and the generation of electricity, and expand the definition of when the manufacturing or other process commences and concludes,
- allow unused credit carryovers to be carried forward indefinitely, and
- delete the repeal date.

SUMMARY OF AMENDMENT

The April 3, 2000, amendments added taxpayers engaged in electric services to the definition of "qualified taxpayer," modified the definition of "qualified property" to include property used in extracting nonmetallic minerals and electric services activities, and made four department-recommend technical changes.

The April 3, 2000, amendments partially resolved the implementation considerations and fully resolved the technical considerations raised in the department's analysis of the bill as introduced February 24, 2000.

Except for the Technical Considerations and Tax Revenue Estimate, the department's analysis of the bill as introduced still applies. A discussion of what the bill does, the department's remaining considerations, the fiscal impact, and the Board position are provided below.

Board Position:			Legislative Director	Date
_____ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Johnnie Lou Rosas	4/19/00
_____ N	_____ OUA	__X__ PENDING		

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SPECIFIC FINDINGS

This bill would increase the MIC from 6% to 8% of qualified costs.

This bill would add taxpayers engaged in extracting nonmetallic mineral activities and electric service activities to the definition of "qualified taxpayer." The extracting nonmetallic mineral activities are described in Standard Industrial Classification (SIC) Codes 1411 to 1499, inclusive, as follows:

- 141 DIMENSION STONE
  - 1411 Dimension Stone
- 142 CRUSHED AND BROKEN STONE, INCLUDING RIPRAP
  - 1422 Crushed and Broken Limestone
  - 1423 Crushed and Broken Granite
  - 1429 Crushed and Broken Stone, Not Elsewhere Classified
- 144 SAND AND GRAVEL
  - 1442 Construction Sand and Gravel
  - 1446 Industrial Sand
- 145 CLAY, CERAMIC AND REFRACTORY MINERALS
  - 1455 Kaolin and Ball Clay
  - 1459 Clay, Ceramic and Refractory Minerals, Not Elsewhere Classified
- 147 CHEMICAL AND FERTILIZER MINERAL MINING
  - 1474 Potash, Soda, and Borate Minerals
  - 1475 Phosphate Rock
  - 1479 Chemical and Fertilizer Mineral Mining, Not Elsewhere Classified
- 148 NONMETALLIC MINERALS SERVICES, EXCEPT FUELS
  - 1481 Nonmetallic Minerals Services, Except Fuels
- 149 MISCELLANEOUS NONMETALLIC MINERALS, EXCEPT FUELS
  - 1499 Miscellaneous Nonmetallic Minerals, Except Fuels

The electric service activities are described in SIC Code 4911 as establishments engaged in the generation, transmission, and/or distribution of electric energy for sale. Taxpayers holding a Certificate of Public Convenience and Necessity issued by the California Public Utilities Commission would not be qualified taxpayers for purposes of the MIC.

This bill would modify the definition of "qualified property" to include tangible personal property (IRC Section 1245(a) property) used by a qualified taxpayer in extracting nonmetallic mineral activities and electric service activities primarily for "extracting property" or "generation of electricity." This bill would further modify the existing law qualified activity definition within the qualified property rules by expanding the commencement point of the manufacturing or other process to include when raw materials are "obtained" within this process.

However, **this bill** would not remove the exclusion of equipment used in the extraction process from the definition of qualified property. Thus, qualified taxpayers would not be able to claim the credit for their extracting equipment.

This bill would change the MIC carryover provision from an eight or ten-year limited carryover to an unlimited carryover. Thus, for taxable or income years beginning on or after January 1, 2000, a taxpayer that is unable to use the entire MIC credit could carry over the credit indefinitely. However, carryovers from taxable or income years beginning prior to January 1, 2000, would continue to be limited.

This bill also would remove the repeal date and the manufacturing employment evaluation from the MIC, extending the credit indefinitely.

Policy Considerations

This bill would raise the following policy considerations.

- When a general sales tax exemption for all manufacturing equipment proved too costly, the exemption was provided to only new manufacturers and the 6% MIC was enacted for other manufacturers as a partial offset against their sales and use tax paid with respect to manufacturing equipment. Moreover, the 1994 amendments to the MIC allowed taxpayers to claim the MIC with respect to their capitalized costs of direct labor, amounts upon which no sales or use tax is paid. An 8% tax credit goes far beyond the 5% sales tax exemption.

- This bill would benefit transactions for which binding contracts already exist and would not be limited to benefit only future business decisions. Contracts entered into after January 1, 1994, but prior to enactment of this bill, already qualify for the credit, and existing binding contracts that require the payment of otherwise qualified costs under the MIC would qualify for the increased MIC benefit (additional 2%) provided under this bill.

- Recently, the policy regarding credit carryover provisions has moved from unlimited carryovers to limited carryovers, as most carryovers are used within eight years. This bill would diverge from that policy. According to the author's staff, this bill will be amended to reinstate the limited carryover provided under current law.

- The bill would amend the qualified activity definition within the qualified property definition by expanding the "process" (manufacturing, processing, refining, etc.) to include "the point at which any raw materials are obtained." Because this change is not limited to the extractive activities added by this bill, it would allow existing qualified taxpayers to claim the MIC for equipment used to transport raw materials from the point that they are obtained (for example, a warehouse owned by the taxpayer) to the actual manufacturing, fabricating, etc., site. Under current law, such equipment would not qualify for the MIC because the MIC is limited to equipment use beginning at the point raw materials are "received." Further, if the term "obtained" were construed to mean the point at which title transfers, then a taxpayer who transported raw materials by trucks which it owned or leased, no matter the distance, would be entitled to claim the MIC for the costs of the trucks. Under current law the trucks would not qualify since they would not be treated as equipment used in the "process" qualifying the taxpayer for the MIC.

- Under current law, the definition of qualified property includes tangible personal property used for specified activities, beginning with the point raw materials are added to the process and *ending at the point the activity has altered tangible personal property to its completed form, including packaging, if required*. This bill would add "extracting" to the list of activities which define the end of the "process."

However, it is unclear whether extractive activities could ever result in the altering of tangible personal property to its completed form and thus the definition may not properly address extractive activities. This could result in some extractive industry taxpayers not being entitled to the MIC as intended by this bill.

- This bill would expand the activity definition within the definition of qualified property to include the generation of electricity. As a result, taxpayers who qualify for the MIC under existing law could claim the MIC for auxiliary activities that satisfy this expanded activity definition. For example, assume a manufacturing plant that includes on its premises a co-generation facility that produces electricity to run the manufacturing line. Under current law, this co-generation facility is properly treated as an auxiliary establishment under the SIC Manual and is assigned the same SIC Code as the manufacturing activity. However, since the generation of electricity is not a qualified activity for MIC purposes under existing law, the costs attributable to the co-generation facility would not qualify for the MIC. However, such activities would qualify under the activity definition provided by this bill.

Implementation Considerations

This bill would raise the following implementation considerations.

- This bill did not modify the definition of qualified property to remove or modify the language that explicitly excludes equipment used in the extraction process. Thus, taxpayers added by this bill would not qualify for the MIC under the bill as currently drafted. This may lead to disputes between taxpayers and the department, as well as not providing the intended incentive. Amendments 1 and 3, provided at the author's request, would resolve this concern.

- MIC carryovers from taxable or income years beginning before January 1, 2000, would continue to be limited. Taxpayers could misunderstand this law and try to claim credit carryovers that have expired. This may lead to disputes between taxpayers and the department.

Technical Considerations

Amendments 2 and 4 would remove the definition of "small business" used for the limited carryover. This definition is no longer necessary since this bill would remove the limited carryover provisions. If the author amends the bill to reinstate the limited carryover provision, these amendments would not be necessary.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

This revenue estimate assumes that the bill will be amended to reflect the author's intent to modify the definition of qualified property to include property used in business relating to extracting nonmetallic minerals.

Revenue losses increased by $14 million for fiscal year 2000-01, $18 million for 2001-02 and $20 million for 2002-03 from the prior estimate because of the amendments extending the MIC to non-utility generators who serve the unregulated market. Based on the data and assumptions below, revenue losses are estimated as follows:

Extending the MIC to nonmetallic minerals and electric services and increasing the credit from 6% to 8% would result in the following revenue losses.

Revenue Impact of AB 2461 04/03/2000 For Taxable/Income Years Beginning 1/1/2000 Assumed Enactment After 6/30/2000 Fiscal Years (In Millions)			
	2000-01	**2001-02**	**2002-03**
Increase MIC to 8% Current Law	-$110	-$133	-$136
Add Non Metallic:			
Under Current Law @ 6%	-$3	-$4	-$5
Increase MIC to 8%	-$1	-$1	-$1
Add Elec. Gen.:			
Under Current Law @ 6%	-$10	-$14	-$16
Increase MIC to 8%	-$4	-$4	-$4
Total Change to MIC	**-$128**	**-$156**	**-$162**

Extending the carryforward period on credits generated after January 1, 2000, until exhausted would result in revenue losses in the $5 to $10 million range annually beginning in fiscal year 2008-09.

Eliminating the repeal date from the MIC would not impact current revenues. It is anticipated that the MIC would not sunset under the current law requirement. Under current law, the MIC will sunset only if employment in manufacturing, not including aerospace, on January 1, 2001, or any January 1 thereafter, "does not exceed by 100,000 jobs the total manufacturing sector employment in this state on January 1, 1994." Employment in manufacturing increased by 136,000 between 1994 and 1997. It seems safe to conclude that the targeted increase will be met and that the current law MIC will remain operative indefinitely beyond 2001. Thus, unless a major change in the economy occurs, eliminating the sunset date would not affect PIT or B&CT revenues.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Tax Revenue Discussion

This estimate is based on data from an U.S. Census Bureau survey of capital expenditures by relevant industries for 1997. The 1997 numbers were grown to approximate 2000 and beyond. The credit use rates taken from the microsimulation model of California tax returns were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on FTB's analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

This estimate does not include losses resulting from qualified taxpayers as defined under current law that might receive additional credit for activities that would qualify under the changes made by this bill (see issues discussed in policy considerations). Such losses cannot be quantified since the data and information needed are not available.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2461
As Amended April 3, 2000

AMENDMENT 1

On page 8, modify line 34 as follows:

(D) Equipment used in the extraction process<u>, except nonmetallic mineral mining activities described in SIC Codes 1411 to 1499, inclusive</u>.

AMENDMENT 2

On page 10, delete lines 18 through 34, inclusive.

AMENDMENT 3

On page 21, modify line 24 as follows:

(D) Equipment used in the extraction process<u>, except nonmetallic mineral mining activities described in SIC Codes 1411 to 1499, inclusive</u>.

AMENDMENT 4

On page 23, delete lines 9 through 25, inclusive.